Archegos: the questions nobody asks

There has been a lot of press articles on the Archegos blow-up. But there are many more questions to be asked that those already pushed out:

The factual background

Archegos Capital Management is a family office, which manages the money of Sung Kook "Bill" Hwang since 2013. Hwang is a "Tiger Cub", a former PM/Analyst from famous Tiger Management. Hwang was managing $500m of his own money, which he earned through his role as a portfolio manager in the previous decade.

Hwang started as a stock Salesman in early 90's at Hyundai Securities. After a legal battled which started in 2009, Hwang and his firm Tiger Asia Management pleaded guilty in 2012 to insider trading & stock manipulation charges. They settled $44m with the SEC and HKD 45m with the HK Securities and Futures Commission.

Archegos is actually the new name of his old company Tiger Asia Management. The firm is based in New York, since Hwang was banned from trading in Hong-Kong in 2014, as well as other Asian markets in which he specialized.

Archegos held large concentrated bets in a few companies, notably ViacomCBS, Discovery, Baidu, Tencent and Vipshop.

Besides his own stock positions (already large), he also held stocks synthetically through swaps at prime brokers.

The primes didn't know of the extent of his other prime relations and how large the positions were. The overall position was not $10bn, but more than $50bn - rumored to reach $100 bn.

The list of affected primes is increasing. Only JP and Deutsche seem to have escaped that wreckage. JP, because they refused to offer services to Archegos, and Deutsche, because they were quick to offload positions.

The unbundling

His large direct and synthetic acquisitions pushed the stocks up, often becoming one of the largest shareholders, just with regular stock ownership.

It is speculated that Hwang accepted, if not bet, on the stock rise since momentum traders would have to follow-up and purchase more shares. The stock would also attract activist retail traders (think "a new GameStop!")

ViacomCBS notably went up 300% in early 2021, surely thanks to its well-delivered online movie platform Paramount+, but surely also thanks to Hwang's purchases.

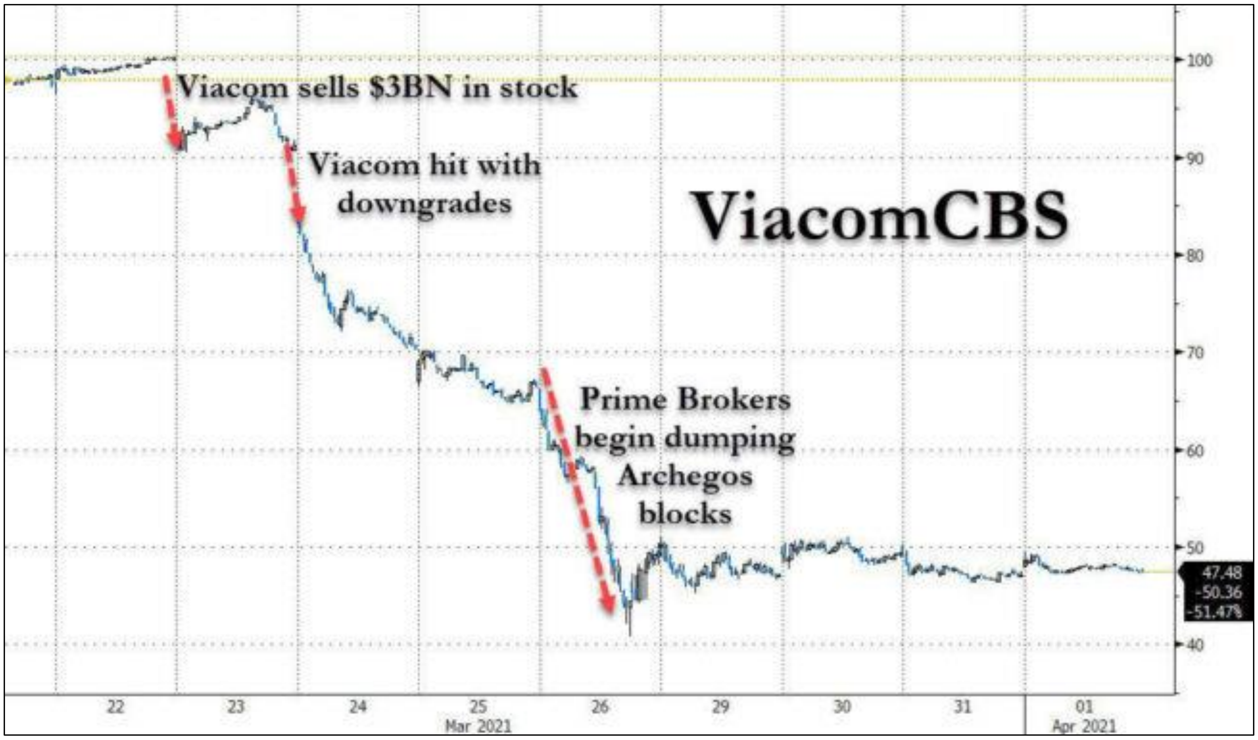
Unfortunately, late on March 22nd, ViacomCBS announced a $3 bn stock and convertible bond sale to cash in on its $100 stock price. The stock dropped 10% on the open.

Analysts announce stock downgrades. The stock loses another $20 in the next few days.

On March 25th, some of the prime brokers called Archegos on margin, or at least to sell some stocks to free capital and meet the margin call. Hwang adamantly refuses - He will never free enough capital, and the stock sale would generate more margin call, starting a snowball effect.

The primes talked to each other that day. Credit Suisse wants to give him a few days. Goldman and Morgan Stanley seized the collateral.

On Friday, March 26th, and maybe during the weekend as well, Goldman sold $3.3bn of ViacomCBS **collateral** via block sales before the open. Deutsche quickly unwound $4bn of shares, notably to Marshall Wace. Morgan Stanley and Wells Fargo followed. The stock ends the day around $45, down 50% from its top.



On Monday, Zurich time, Credit Suisse announces that it faces a "highly significant loss". Its share fell 21%. The rumor mill indicates $4-5 bn of losses. The firm, which recently took losses for the Luckin Coffee fraud, the Greensill Capital collapse, as well as a laundry list of other compliance issues, is now considering exiting its CRO and its investment bank head (respectively Lara Warner and Brian Chin). Closer to home for the shareholders, Credit Suisse has a CHF 1.5 bn ($1.6bn) share buy-back in progress, which is now at risk.

Nomura announced a $2bn loss. The stock barely moved.

JP Morgan estimates there is $10bn of loss spread between Wall Street banks.

The questions everybody asks

Archegos was estimated to have $10 bn of capital at the time of the events.

At the time of its wreck, the fund was rumored to have 50-100bn of exposure through swaps. That would be a 5x - 10x leverage on an indicated capital of $10 bn. That level of leveraged is rarely offered by primes. Only the biggest, most diversified and excellent risk manager hedge funds like Citadel or Millennium are offered that type of leverage. A concentrated stock picker would be offered probably around 2x, at best 3x.

The reason Archegos was able to gain such high leverage, was because the primes didn't know of the existence of so many other prime brokers (8?) supporting Archegos... in the same trades! There is a structural issue at the confluence of confidentiality and leverage here.

Hwang had a checkered past. He was caught manipulating stocks, and trading on insider information. He was a persona non grata in Asia. Why was he offered so much leverage in the US? We all know that primes prefer big famous PMs to smaller less-known PMs, but there are some risk-management issues to be learned here.

The fact that a fund was able to leverage so much - and costing so much to Wall Street - by hiding its multiple swaps is a glaring fault from a risk-management perspective.

- The world of prime brokerage and swap trading is competitive, and banks do not disclose to each other how much leverage they extend to their clients (or even which clients they have).
- In a world with low interest rates, the client-facing synthetic equity business is valuable. It is mathematically market risk-free (no VaR, only credit risk), while real money (institutionals and family offices) are considered very safe credit-wise. It is also profitable, with probably 20-40 bp margin, posted against a highly leverageable balance sheet.
- Building prime brokerage activities is not cheap - systems, staff, compliance, support functions, etc, requirement top dollars. Banks have heavily invested in the activity, because prime brokerage becomes highly profitable when it reaches a critical mass of large hedge funds and family offices.
- As a result, banks are bending over backward to attract and keep these top clients. This explains why Archegos was able to bend the rules and acquire extra leverage.

The Archegos situation is also a problem from a regulatory perspective.

- There is no disclosure requirements for family offices, which are neither banks (heavily regulated) nor hedge funds (lightly and recently regulated).
- Family and multi-family offices are now managing an estimated $6 trillion in assets. [Family offices are investment vehicles for a single investor. Because a 401(k) also fulfills that definition, a minimum of $100m in assets is usually considered as a minimum. If there are probably 50k individuals with that wealth, and 5-10k are managing their wealth themselves in a family office.]
- For comparison, the ETF business is now around $7.5 tn, and it is highly regulated and closely monitored.
- Now, there are plenty of criticism already about the source of the wealth from wealthy families, or how they (mis-)manage their wealth, or how they influence the world... Some of these questions deserve to be asked if there is some wrongdoing. But I think also that people are entitled to some privacy. If Bill Gates wants to invest into farm land or Coca-Cola, that is his absolute right and none of our business. Which means regulating family office and private wealth like other asset managers is probably over-the-top.

The questions nobody asks

There are some inconsistencies in the currently available information. Here are some of the questions which needs to be asked:

If Hwang started with $500m, where do these $10bn come from? Archegos is said to be a single-family office, and therefore has no other investors.

- Now, Archegos would have leveraged 500m into $10 bn of assets by trading stocks on margin. A 20x leverage? Unlikely.
- Archegos accumulated gains from $500m to $10bn. A 20x gain over 6 years cannot happen unless you are highly leveraged. And if you are highly leveraged, the losses can be as fast as the gains.
- or a combination of both.
- Anyhow, it is obvious that Archegos was highly leveraged.

We do not know the origin of the $10 bn he was indicated as managing. Was he managing money from other investors in his family office? He may be swimming with concrete shoes sooner than later.

We have no true idea of Archegos positions. Right now, we only hear rumors on positions and leverages. JP says there is $10 bn of losses between the various PBs. Where is that information coming from?

Hwang has managed a hedge fund. He knows the difference between long-only and long-short. Was he really long only, without market hedge, with his own money? Was he actually shorting stocks against his known longs, in a relative value play?

- The $50bn would be the gross capital, aka 2x $25 bn. That reduces the leverage by as much. But we haven't heard of any short wins/losses.
- Also, even $25bn of S&P futures creates a lot of margin calls when the S&P goes from 2,500 to 4,000+...

The prime-brokers would have had a conversation on March 25th to decide between themselves what to do with the Archegos situation. That a conversation between primes is hard to believe:

- They are bound by confidentiality requirements. They simply are not allowed to discuss their clients' positions to anybody but regulators.
- The PM would have had to agree to the call, if not be present on the call. Why would Hwang have agreed to that call?
- Prime brokers talking between themselves of the overleverage? Credit Suisse asking for time? That's not how it works. As soon as the PB would have realized the extent of the issues from the conversation, they would immediately have started liquidating the positions. The first to rush to the door has a chance to make it alive. The 3rd or the 5th do not. It is unlikely they would discuss such a coordinated action, because they know that the brokers were not going to respect the rule.

How is it possible that PBs would have lent billions based on Archegos STATED (not deposited) AUM? Primes lend based on the money deposited on their account. If Archegos say that it is worth $10bn, but deposits only $1bn, a prime would only leverage the $1bn, not the $10 bn. So how could we reach $50 or $100bn of TRS?

Also, primes do not decide, but calculate, the amount of leverage to be allowed. They take into account the type of risks (concentration, availability of information...). They use complicated formula and processes. It would be a major faux-pas to over-ride those processes.

Did the prime brokers really didn't know that he was building large positions through swaps? Maybe Hwang had good insider information and he was avoiding regulatory scrutiny by using swaps? If the brokers knew, then willful blindness could be another word to describe this situation.

I have never met Hwang. Some of my contacts have. He doesn't appear to be a perfect angel. Prime brokers are market professionals who have seen a lot. He may be a messianic and charismatic presence (large charity donations, an openly strong God-believer, running bible groups...), but the insider trader and the rule bender are also visible. Settling $50+m with the top regulators for criminal charges is no small amount. How would so many prime brokers leverage someone with such a past and such a dubious character?

Could it be, that primes got additional information about Archegos that has not been disclosed yet, say an investigative letter from authorities for instance, and decided to unwind the positions for that reason?

IMO, we do not have enough information at this stage to truly understand what happened. In other words, the SEC needs to open an investigation... if it has not started already.

This investigation will be private, but some statements will surely follow in the months and years to come...

Sources

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Gontran de Quillacq

Gontran de Quillacq is a leading authority and thought leader in options, trading, derivatives, and complex securities. He has 25 years of experience in derivatives, structured products, proprietary trading, portfolio management and investment research. He has worked with top-tier banks and hedge funds in both London and NYC.

de Quillacq is a recognized financial instruments and securities litigation securities expert with a deep and current industry know-how, as well as an exceptional background.

Options, derivatives and structured products are highly complex securities. Academia and books can lead to basic understanding and competency, but mastery and subject matter expertise can only come from deep industry experience. Mr. de Quillacq has the unique ability to explain difficult and complex securities issues; communicate them with clarity and authority; and present them in a convincing and pleasant manner.

BACKGROUND EXPERIENCE

After his European and US education, Mr. de Quillacq traded derivatives for 25 years, from vanillas to exotics, both proprietary and client-facing, at top-tier banks in the square mile and on Wall Street. As a portfolio manager, he researched and managed investment strategies, delivered both in hedge fund and in structured note formats. He initiated the distribution of investment strategies through derivatives, an activity now called 'portable alpha' and 'smart beta'. For the following five years, Mr. de Quillacq ran due diligence on investments strategies and selected senior investment personnel for some of the world's most famous and most demanding hedge funds and asset managers. In 2017, he co-founded a quantitative activity deploying the latest machine learning techniques in global long/short equities. In 2019, Mr. de Quillacq joined a New York hedge fund deploying volatility trading strategies as a COO and quantitative researcher.

EXPERT WITNESS & LITIGATION SUPPORT

Mr. de Quillacq's own investment experience and his cross-sectional review of other professionals give him unique experience on what can be done, what should be done, what should not be done, and the grey areas in-between. During a personal case, his legal team was so impressed by his wide and thorough knowledge in finance, his capacity to explain complicated ideas in simple terms, and his strong performance on the stand, that they strongly recommended he expand into litigation support services.

Mr. de Quillacq is now a leading expert, a FINRA/NFA arbitrator, a member of the Securities Expert Roundtable and an IMS Elite Expert. He has consulting affiliations with Ankura, Barrington Financial Consulting Group, The Bates Group, Eleven Canterbury, Global Economics Group, Moskalev Consulting and SEDA Experts.

FINANCIAL TRAINER

Education is an important component of risk management and efficiency in any financial entity. Mr. de Quillacq regularly conducts educational presentation, in-person and online, as well as produce customized written educational materials to financial industry professionals.

ACADEMIC BACKGROUND

Mr. de Quillacq is an alumnus of the Ecole Normale Supérieure de Lyon in theoretical physics, obtained his doctoral degree (DEA) in electrical engineering at Sup'Elec and became in 1995 an alumnus of HEC Paris (MBA, Finance). He was an international fellow in atomic physics at the Stanford Research Institute and a visiting scholar in differential algebra at UC Berkeley. Mr. de Quillacq served as an army officer at the time of the first Gulf War.

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